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# DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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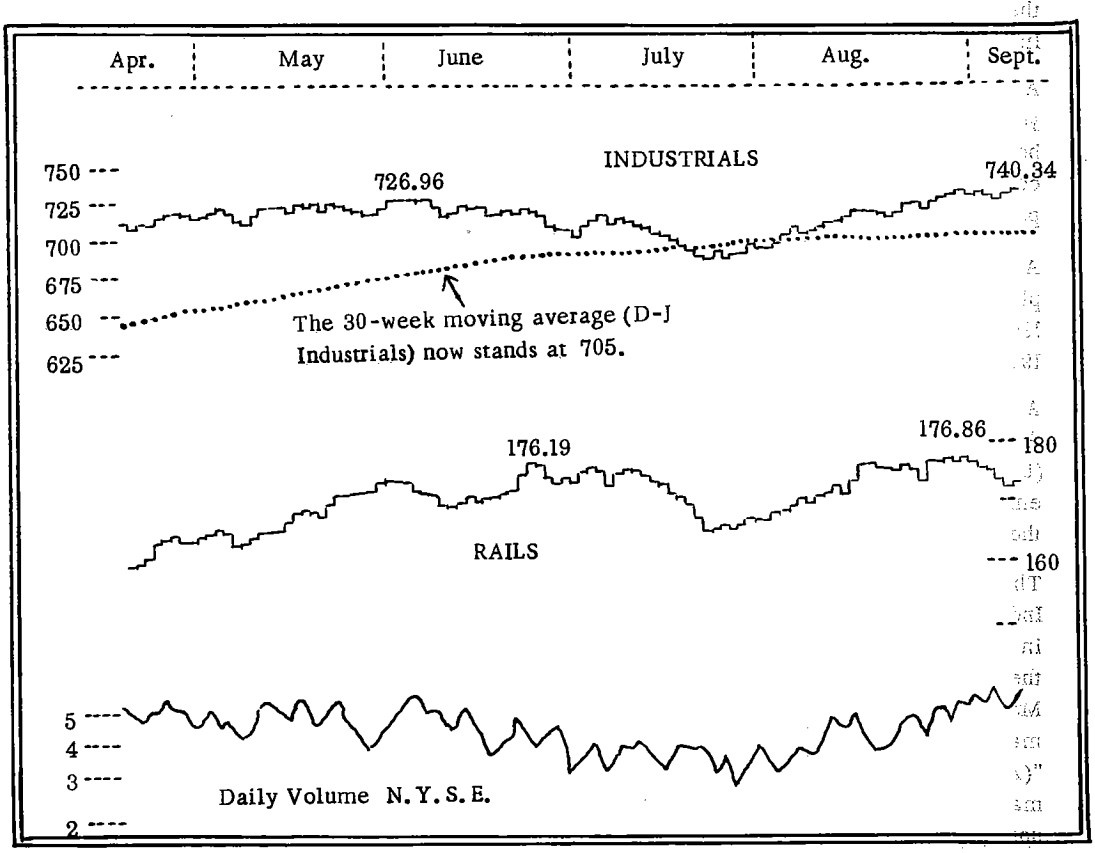
THE MARKET Among the many people with whom this writer corresponds is a gentleman (from Philadelphia) who has been observing and writing about the market since the 1930's. One of this man's favorite expressions is: "The burden of proof is on the bulls" or "The burden of proof is on the bears". What he means is that once a trend is firmly established, it is best to consider that trend as remaining in force (until definitely proved otherwise). It is true that every trend is eventually reversed, but, as William Hamilton was fond of pointing out, much money has been lost by investors and traders who were "...right too soon."

At present we have an erratic, explosive market, a market which (1) has been in a rising trend for 15 months, and (2) now provides average stock yields of approximately 3.2% -- well within the classic "danger zone" of overvaluation. Nevertheless, the general appearance of the market is of "upside power". The last Letter discussed the possibility of a coming speculative renaissance. This Letter deals with technical problems which may or may not allow for a "market boom."

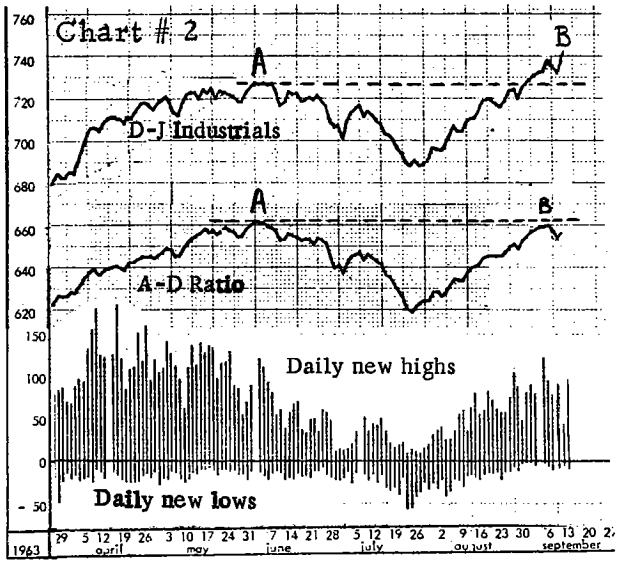
From the standpoint of the price movement, the following observations are in order. On August 30, the Rail Average rose to 176.86, the highest level since the 181.23 peak of 1956. Three days after the 176.86 Rail high, Industrials hurdled their own 1961 peak of 734.91 and rose to an all-time high.

However, instead of continuing to advance with Industrials, Rails turned down on September 3 and declined (diverged) steadily. Even the record (Industrial) high day of September 5 brought lower Rail prices. Persistent divergence in the two Averages (particularly if accompanied by high volume) is always a cause for concern. Such action (in the past) has frequently meant distribution. As matters stand, it will take a new high by Rails above 176.86 to confirm the successive all-time highs now being established by the Industrial Average. Conversely, a refusal by Rails to better their recent 176.86 peak will introduce a definite element of danger into the price structure.

The "undertone" action of the market at and around the September 5 peak was rather "negative" in appearance. Daily new highs have been unimpressive during the entire July-September advance (see chart #2). On September 3, new highs touched a peak of 122; on September 2, new highs declined to 95; on September 5 (the day of the historic Industrial peak) new highs declined to 78. The implications of this action were obvious -- fewer and fewer stocks were willing to follow the Industrial Average into new high territory (see Letter 228, page 2).



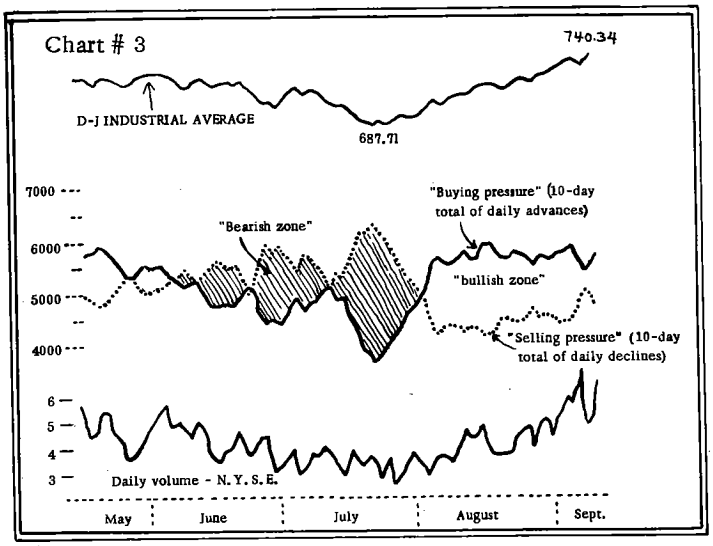

The second matter is of greater significance -- as this Letter is written an important non-confirmation exists between the Industrial Average and the advance-decline ratio (see chart #2). On May 31, 1963, both the Industrial Average and the A-D ratio registered peaks (at A on chart). Following a reaction during June and July, Industrials rose to a new all-time high this week, but the A-D ratio has (so far) failed to confirm (B on chart).




This action puts the market on the brink of one of those technical "crises" of the type that has been successfully concluded so many times in the past fifteen months. If the trend is to remain bullish, then the A-D ratio must now push beyond its May 31 peak. A persistent refusal by the A-D ratio to "perform" in the face of successive Industrial highs has (in the past) spelled certain danger.

To put it more strongly, the ability or inability of the A-D ratio to better its May 31 peak will decide whether the 1962-63 rise has a new lease on life -- or whether the 1962-63 advance is essentially over. It is no longer a case of guessing; it is a matter of watching the market itself.

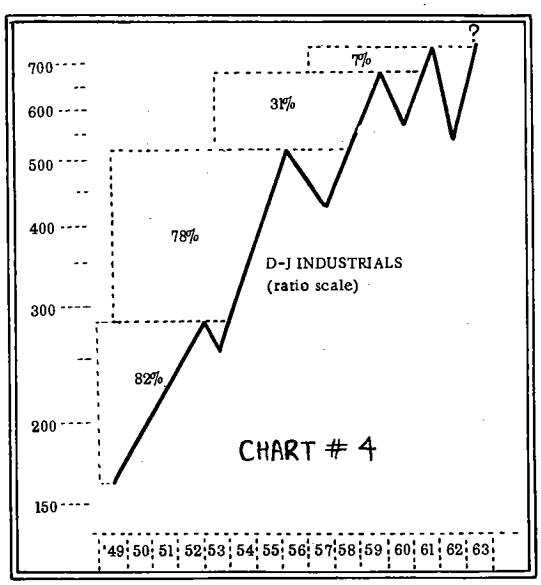
BUYING AND SELLING PRESSURE Early this week the buying and selling pressure lines came close together on high volume. However, it usually takes an actual crossing (with selling above buying) before real market weakness appears. Since September 9, the two lines have tended to draw apart again with buying rising and selling dropping. Until the two lines establish a bearish crossing, the implications of this study will remain bullish (although the study does suggest that the mass of issues are not showing the rallying power now being displayed by the Industrial Average alone).




PERCENTAGES Chart #4 is drawn to ratio scale and accurately portrays percentages of advance or decline. This chart traces the major swings in the D-J Industrials during the period from 1949 to the present. The implications of this study are interesting and are worth considering at this time.

The first major swing from the 1961.60 level of June, 1949, to the 1953 high of 239.79, advanced the Industrial Average a whopping 82%. A reaction occured from the 1953 peak. Following the reaction, Industrials turned up again. The senior Average bettered the 1953 high in February, 1954. The advance beyond the old 1953 high to the 1956 peak of 521.05 added 78% to the Industrial Average.

A second major reaction came in late 1957. In October of that year the Industrials turned to the upside. The old (1956) high of 521.05 was bettered in September, 1958, and this was followed by a major advance which continued to a January, 1960, peak of 685.47. This advance added 31% to the peak Industrial price established in 1956.




A third important decline occured in 1960, with a reversal to the upside taking place in October of that year. The 1960 peak of 685.47 was bettered in April, 1961. However, the Industrial Average was able to add only 7% to its previous 1960 peak before "topping out" in December, 1961 (at 734.91).

A fourth major decline occured in 1962, and here for the first time the Industrial Average (confirmed by Rails) broke below a previous important reaction bottom (below the 1960 bottom). Despite this bearish action, the Averages in June, 1962, embarked on a fifth upward leg. On September 5, 1963, Industrials bettered the 1961 peak of 734.91.

The obvious question which arises in connection with last week's new high on the Industrial Average is: "Will the percentage of increase on this advance follow in the pattern of the last four advances? In other words, will the advance beyond the 1961 peak of 734.91 carry to less than 7% in extent? Along these lines, Mr. Humphrey Neill in his latest Letter of Contrary Opinion notes that "The majority opinion at this writing is optimistic for both business and the stock market." This leads Mr. Neill to ponder whether "(A) the business boom may lack sufficient momentum to maintain its upward course", and "(B) the stock market likewise may have used up its strength from professional sources; and requiries 'public participation' for further substantial progress on the upside."

Actually, this is the same question which has been posed in recent Letters: "Will the public come back to the market -- or (like 1947 and 1948) will the Industrials stop around the old highs and sink back again through lack of public interest?

MORE ON RELATIVE STRENGTH I have found it helpful to think of relative strength (R. S.) in terms of "popularity". When a stock or a stock group is improving in relative strength, its popularity is increasing. The question then arises — when is the best time to buy on the basis of relative strength data?

Two factors are involved in answering this question. (1) Where is the group in terms of its relative strength history? (2) Is the group at or near a reversal in relative strength?

Obviously, the ideal time to purchase would be when a group is way down in terms of popularity and as that group once more begins to come into popular favor (i. e., a reversal to the upside in a R. S. line at a time when that line is at a very low historical level).

Few analysts have studied the long-term swings in R. S. carefully, but one man who has is Mr. Robert Coltman (Vice-President of the Philadelphia National Bank). A few years ago Mr. Coltman drew up the following interesting table. It shows two investors, each starting with a theoretical $1,000 account. Investor "A" was a "lone wolf". He bought only the most out-of-favor groups. Investor "B" was a prudent man. He purchased only the "hot merchandise", the popular groups. The record below shows what happened:

| | A to start | end of period value $ 1,000 | B to start | end of period value $1,000 |
|---|---|---|---|---|
| 1911-1920 | Held oils ..... | 1,880 | Held utilities ..... | 640 |
| 1920-1929 | Held utilities ..... | 10,020 | Held oils ..... | 1,080 |
| 1929-1957 | Held oils ..... | 39,000 | Held utilities ..... | 660 |
| 1957-1961 | Held utilities ..... | 71,400 | Held oils ..... | 680 |

(without deduction for brokerage or capital gains tax)

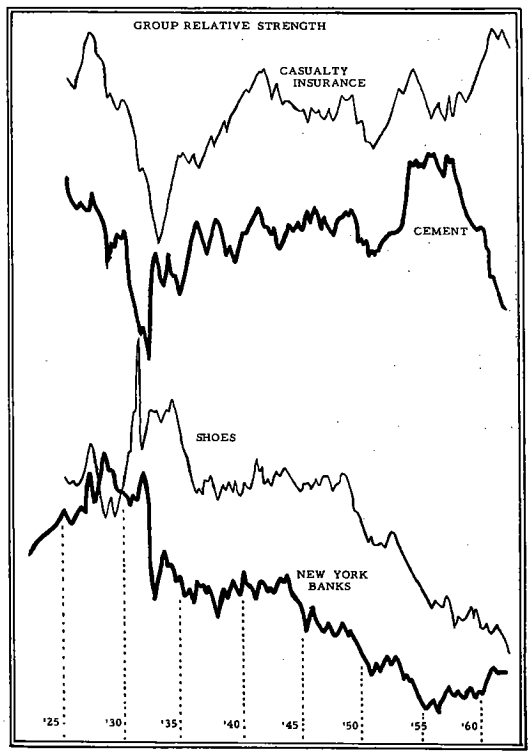
Of further interest is the fact that during August-September, 1961, Mr. Coltman wrote the following (regarding the weakest groups): "Doghouse Specials of 1961 include Rails, Canadian gold stocks, lead and zinc shares and shoe stocks." Of these four unpopular groups, only the last has not done well since then.

I have been lucky enough to obtain long-term charts of group relative strength going back in many cases into the early 1900's and before. These charts allow for important historical comparisons, and I will comment from time to time regarding group standing in the light of past R. S. history.

At any given time there are usually a number of stock groups which are near their highest or lowest level in history. When an investor buys a stock in a group which is at its highest level of popularity, he is "running with the crowd" (although this does not mean that the groups will not go even higher in popularity). However, if a group is near its low in popularity and then turns up, it usually represents a "bargain".

What about stock groups in the current market. At present the following groups are at or near their all-time peaks of R. S. Autos -- highest R. S. in their history; Casualty insurance — highest R. S. since 1929 (see chart below which is courtesy of Ray * Signals, 141 Broadway, N. Y. C.); Office equipment -- near its highest R. S. in history; Retail mail order -- at its highest R. S. in history. In other words, those who buy into these groups are buying stocks which are at or near their most popular levels in a generation or longer.

On the other hand, the following groups are now way out of favor: Shoes (see chart) -- currently at their lowest level on record; Copper and Brass -- lowest R. S. since 1932; lead and Zinc — lowest since 1907; Railroad equipment -- lowest since 1882 when the figures were first available; Retail variety chains — lowest in a generation or since 1921; Steel and Iron -- lowest since 1944; Agricultural equipment -- lowest since the mid-1920's. New York Banks -- in the low region of the last 35 years (see chart) but now in the process of turning up.



The question: would one be better off investing in the most popular or the least popular stocks of 1963? My bet is that long range purchases would be more apt to show up well if confined to the best values in the least popular groups and that in general stocks which are near their highs of popularity should be gradually distributed.

LATE NOTES The relationship of the Industrial Average and the A-D ratio grows more interesting. On May 31 both indicators touched recovery highs. Following a reaction, Industrials touched a new all-time high on September 5 -- but the A-D ratio refused to confirm (would not better its May 31 peak). A two-day decline followed, and on September 11 Industrials rose to another new high of 740.34. But this time the A-D ratio would not even better its September 5 peak. Thus we are building a series of non-confirmations between price and breadth. Unless the A-D ratio can show renewed strength, this could develop into a dangerous situation. For this reason, I would defer any buying until it is clear that the A-D ratio has bettered its May 31 peak (see page 2, chart 2).

Of further interest: between August 30 and September 9 (8 trading days) the Industrial Average held within an 11 point range. During this period 46 million shares changed hands. As this is written, Industrials are still within their 11 point peak range. In other words, the biggest volume of 1963 has been unable to "move" the market higher.

STOCKS Of 432 representative N.Y.S.E. issues which are tabulated here weekly, 361 or 84% are now holding above their 30-week moving average (an improvement of 6% from last week).

Two group relative strength charts are particularly significant at this time. The chart below shows the long decline in Rail R.S. through 1959, 1960 and most of 1961. In January, 1962, Rail R.S. turned up, and by late 1962 Rail R S. was improving on a steadily rising trend basis (trendline A). Last week this trend was broken. The turn in Rail R.S. is not bullish for the rail equities and it is probably not bullish for the market.

R.S. in the Paper group turned down in December, 1960; it has been going down ever since. But over the past two weeks this long decline in Paper's R.S. was reversed to the upside. Small charts below show two leading paper stocks. International Paper is the giant of the group. The stock is in the Industrial Average and has been one of the laggards. Lately IP has shown signs of wanting to move out. The 30-week moving average on IP is now at 30 (dotted line on chart). St. Regis Paper is one of the speculative paper stocks. SRT possesses a large debt structure and is therefore leveraged. Selling in the same range as IP, SRT is capable of earning more per share (almost $3.00 per share in 1959). SRT has recently bettered its moving average which now stands at 31.

The Steel group is also on the verge of turning up in R.S. Strongest stock in this group is Jones and Laughlin which has far-outspaced the old leaders, U.S. and Bethlehem.

Charts of IT and SRT courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas

Relative Strength charts and chart of Jones & Laughlin courtesy of Traders Research, 1431 Pearl Avenue, Alton, Illinois 62003.